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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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FEB 23 2011

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2011 FEB 23 P 3:19

AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
ARIZONA WATER COMPANY, AN
ARIZONA CORPORATION, FOR A
DETERMINATION OF THE FAIR VALUE OF
ITS UTILITY PLANT AND PROPERTY AND
FOR ADJUSTMENTS TO ITS RATES AND
CHARGES FOR UTILITY SERVICE
FURNISHED BY ITS WESTERN GROUP
AND FOR CERTAIN RELATED
APPROVALS.

DOCKET NO. W-01445A-10-0517

**STAFF'S RESPONSE TO ARIZONA
WATER COMPANY'S MOTION FOR
PROCEDURAL ORDER REGARDING
SUFFICIENCY OF APPLICATION**

The Utilities Division of the Arizona Corporation Commission ("Staff") hereby responds to Arizona Water Company's ("AWC") Motion for Procedural Order Regarding Sufficiency of Application ("Motion"), and respectfully requests that the Commission deny AWC's Motion. Alternatively, should the Commission determine that AWC's test year is sufficient for purposes of Arizona Administrative Code ("A.A.C.") R14-2-103, Staff hereby requests that the Commission determine that AWC's application is not suitable for ratemaking purposes under the circumstances presented by this case. If the Commission agrees with Staff on either of these contentions, Staff is not at this time suggesting that the case be terminated. Instead, Staff requests that the Commission retain this matter and require AWC to file an application with an appropriate test year, as outlined below.

In the event that the Commission decides to accept AWC's present application as both sufficient and suitable for processing, Staff requests that the Commission waive or suspend the time period set forth in A.A.C. R14-2-103(B)(11)(d) due to the Company's use of an unconventional test year. As Staff will articulate in a forthcoming filing, it believes the issue of sufficiency in this matter may be most appropriately determined through a Commission decision.

...

1 **I. BACKGROUND.**

2 AWC filed its application on December 29, 2010, utilizing a test year ending December 31,
3 2009. The application requests an order approving certain adjustments to its rates and charges for
4 utility service provided by the Western Group water systems in Arizona. The Commission
5 authorized the Company's current rates for the Western Group, in part, in Decision No. 71845 on
6 August 25, 2010, which became effective on July 1, 2010. The effective date is well after the end of
7 the proposed 2009 test year.

8 On January 7, 2010, pursuant to A.A.C. R14-2-103(B)(7), Staff filed and served notice to
9 AWC that its application was found deficient because the test year used in support of the application
10 does not meet the requirements of A.A.C. R14-2-103(A)(3)(p). Staff further requested that the
11 Company withdraw its application because Staff cannot process an application that is deficient. The
12 Company's failure to submit a rate application that utilizes a historic test year wherein the
13 Company's present rates were in effect is the basis upon which Staff withheld sufficiency. This
14 fundamental flaw in the Company's application prevents Staff from finding the application sufficient.

15 **II. STAFF'S RESPONSE TO ARIZONA WATER COMPANY'S MOTION FOR**
16 **PROCEDURAL ORDER REGARDING SUFFICIENCY OF THE APPLICATION.**

17 **A. Arizona Water Company's Rate Application Is Not Sufficient.**

18 AWC's most recent Western Group rates went into effect on July 1, 2010, 182 days
19 (approximately six months) after the end of the Company's new proposed 2009 test year. The
20 Company's hypothetical projection of current rates to the proposed 2009 test year amounts to a
21 projected or future test year.

22 ***1. The Company's application is insufficient because it does not meet the***
23 ***definition of a historic test year.***

24 A.A.C. R14-2-103(A)(3)(p) defines "test year" as "[t]he one-year historical period used in
25 determining rate base, operating income and rate of return." The rule goes on to state, "The end of
26 the test year shall be the most recent practical date available prior to the filing." It is within

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1 the Commission's sole discretion to utilize a historic test year ratemaking methodology, and the
2 Commission is not required to utilize a speculative or post-test year ratemaking methodology.¹

3 The Commission is owed deference in interpreting its own rules--in this case, the rate case
4 management rule.² As the Commission noted in Decision No. 57875, the decision approving the
5 amendments to the rate case management rule in 1992, "[t]here is no dispute that evaluating a
6 utility's rate filing for compliance with the applicable requirements is a technical matter which falls
7 squarely within Staff's expertise."³ Agency practice indicates that the Commission has interpreted
8 the rate case management rule consistently to require actual test year data with at least a minimum of
9 six months of the company's most recently approved rates in effect. *See, e.g.*, Docket No. E-
10 01345A-08-0172. This comports with the American Water Works Association's⁴ definition of a
11 historical test year "as a prior 12 month period for which actual operating data are available."⁵
12 Clearly, actual operating data includes the present rates authorized by the Commission.

13 Just as Arizona Public Service Company ("APS") attempted in *Arizona Corporation*
14 *Commission v. Arizona Public Service Co.*, AWC is attempting to force the Commission to consider
15 post test year data by utilizing a test period requiring speculation as to the effect of the currently
16 authorized rates on the 2009 test year. As noted in *The Regulation of Public Utilities: Theory and*
17 *Practice*,

18 ...

19 ...

20 ...

21 ...

22 ...

23 ¹ *Arizona Corporation Commission v. Arizona Public Service Co.*, 113 Ariz. 368, 370-371, 555 P.2d 326, 328-329
24 (1976)(holding that in exercising its broad rate making power, the Commission cannot be required to utilize a future or
speculative rate making methodology).

25 ² *See Marlar v. State*, 136 Ariz. 404, 411-412, 666 P.2d 504, 511 - 512 (Ariz.App.,1983) (citing *Industrial Commission v.*
Harbor Insurance Co., 104 Ariz. 73, 76, 449 P.2d 1, 4 (1968) and *City of Mesa v. Killingsworth*, 96 Ariz. 290, 296, 394
P.2d 410, 414 (1964)).

26 ³ Decision No. 57875, Attach. B at 11:23-25.

27 ⁴ According to direct testimony in W-01445A-04-0650, William Garfield, AWC's president, was a member of the
American Water Works Association, and served on the Association's Water Meter Standards Committee. Garfield Direct
at 2:24-27.

28 ⁵ American Water Works Association, Principles of Water Rates, Fees, and Charges, Manual of Water Supply Practices 8
(2000).

1 The company, *with the concurrence of the commission or its staff*, will
2 generally select a "test year," frequently the latest twelve-month period *for*
3 *which complete data are available*. The purposes of such a test year are as
4 follows. In the first place, the commission's staff must audit the utility's
5 books. For rate-making purposes, only just and reasonable expenses are
6 allowed; only used and useful property (with certain exceptions) is permitted
7 in the rate base. In the second place, the commission must have a basis for
estimating future revenue requirements. This estimate is one of the most
difficult problems in a rate case. A commission is setting rates for the future,
but it has only past experience (expenses, revenues, demand conditions) to
use as a guide. "Philosophically, the strict test year *assumes the past*
relationship among revenues, costs, and net investment during the test year
will continue into the future."⁶

8 Here, the Company is asserting that Staff should be required to process an insufficient application
9 that destroys the relationship among the test year components by employing an unprecedented
10 twelve-month pro forma adjustment, *i.e.*, using rates that were not in effect during the test year. Such
11 an application is not sufficient, and the Commission is not required to accept the application as
12 sufficient.

13 Since the Company's current rates were not in effect at any time during the Company's
14 proposed test year, the relationship between its current rates, and therefore revenues, and its proposed
15 test year expenses and net investment is speculative. Operating income must be measured by
16 matching expenses against revenues generated during the same period, *i.e.*, the test year. Matching of
17 revenues and expenses occurring in the same period is a fundamental accounting principle and the
18 basis of the accrual accounting method required by the National Association of Regulatory Utility
19 Commissioners Uniform System of Accounts.⁷ The Company's rate case, as filed, violates this
20 fundamental accounting and ratemaking tenet. In the ratemaking context, matching includes
21 measuring rate base as well as revenues and expenses for the same period. The Company's use of a
22 pro forma adjustment for all the test year revenues distorts this matching relationship beyond what
23 the Commission reasonably permits in A.A.C. R14-2-103(B).

24 The Company cites several Commission decisions, claiming that Staff has previously found
25 other companies' applications sufficient, even though those applications employed test years using
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27 ⁶ Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* 196 (Public Utilities Reports, Inc. 1993)
(1984) (emphasis added).

28 ⁷ National Association of Regulatory Utility Commissioners Uniform System of Accounts For Class A Water Utilities 48
(1996).

1 less than twelve months of actual rates.⁸ However, the Commission issued all five of these decisions
2 (Decision Nos. 54247, 67744, 55118, and 55228) prior to the adoption of the current rate case
3 management rule. Furthermore, Decision No. 54247 presented circumstances entirely different from
4 the present facts. Decision No. 54247 was the second Commission decision in “bifurcated
5 proceedings in APS’s application for a two-step increase in electric rates.”⁹ Similarly, Decision Nos.
6 55118 and 55228 represented two phases in a single Commission proceeding in Docket No. U-1345-
7 85-156. Finally, it appears that AWC is incorrect regarding Decision No. 67744. Staff believes that
8 the test year utilized by APS in that case included actual test year data with current rates in effect.

9 Since the inception of the current version of the rate case management rule, Staff has
10 generally not found a rate case application sufficient with less than six months of actual test year data
11 with current rates in effect. Interestingly, it appears that Arizona Water Company also understood
12 this requirement because until now it has never filed a rate case utilizing a twelve month pro-forma
13 adjustment to account for rates not authorized during its proposed test year.

14 The Company states, without citing to any authority, “If Staff unilaterally ceases to work on
15 the Application without statutory or other authority, the Application must be deemed sufficient as of
16 January 28, 2011.”¹⁰ This argument ignores the plain language of the rate case management rule.¹¹
17 A.A.C. R14-2-103(B)(7) states,

18 The staff will review each filing to ascertain whether it is in compliance with
19 the provisions of this Section, including the instructions contained in
20 subsection (B)(9) or in forms prescribed by the Commission. Within 30 days
21 after receipt of the utility’s filing, the staff shall file with Docket Control and
22 serve on the utility a notice that the filing either is in compliance with the
Commission’s requirements or is deficient. A notice of deficiency must
include an explanation of the defect found. If the staff fails to file any notice
within the 30-day period, the utility’s filing shall be deemed accepted as of
the 31st day.

23 Contrary to the Company’s assertion, Staff provided the Company with a deficiency notice providing
24 an explanation of the “defect found,” as well as a recommendation to remedy the deficiency. The
25 mere fact that the Company disagrees with Staff’s basis for finding its application deficient does not
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27 ⁸ Decision Nos. 54247, 67744, 55118, and 55228.

⁹ Decision No. 54247 at 2:24-26.

28 ¹⁰ Arizona Water Company’s Motion For A Procedural Order Regarding Sufficiency of Application at 5:5-7.

¹¹ A.A.C. R14-2-103(B)(7)

1 mean that it will automatically be deemed sufficient through the passage of time. The Company may
2 take the appropriate steps to have this dispute resolved by the Commission.¹²

3 **2. *The Company's application is insufficient because it does not utilize the most***
4 ***recent practical test year end date.***

5 The Company's application also fails to meet sufficiency requirements because the last day of
6 the proposed 2009 test year, December 31, 2009, is not the most recent "practical date available,"
7 prior to the Company's December 2010 filing. The Company argues that "[t]he 2009 test year
8 utilized by Arizona Water Company was the most recent recorded *calendar* year available at the time
9 the Application was filed."¹³ An appropriate test year for Commission ratemaking purposes does not
10 have to be a calendar year. The Company fails to explain why it could not utilize a test year based on
11 something other than a calendar year. Staff regularly processes rate case applications that utilize non-
12 calendar based test years. *See, e.g.,* W-01303A-10-0448, E-04100A-04-0527, and SW-01428A-09-
13 0103. Clearly, the most recent, practical date available to the Company prior to the filing of the
14 instant rate case application is not a test year ending December 31, 2009. This date, which is almost a
15 year prior to the filing date of its application, fails to take advantage of actual data under the
16 Company's current rates. Had the Company chosen a test year with a more recent end date, the
17 Company's current rates would have been in effect for at least a portion of that proposed test year.
18 Thus, the Company's use of a test year ending one year before filing this application, wherein present
19 rates were not in effect, deems the application insufficient.

20 **3. *A.A.C. R14-2-103(B)(11)(g) does not allow a company to utilize a test year***
21 ***without any period of actual data including current approved rates.***

22 AWC cites to A.A.C. R14-2-103(B)(11)(g) for the proposition that the rate case management
23 rule does not require "a utility to wait for *any* actual experience under new rates." Specifically, AWC
24 asserts that because this rule contemplates a utility being able to have more than one rate application
25 pending before the Commission at the same time, there is no requirement that test years include
26 actual experience under new rates. However, AWC's interpretation is incorrect. In Decision No.

27 ¹² Decision No. 57875, Attach. B at 12:6-9.

28 ¹³ Arizona Water Company's Motion for a Procedural Order Regarding Sufficiency of Application at 6. (Emphasis added).

1 57875, wherein the Commission amended this rule, the Commission explained that the rule applies to
2 circumstances where a utility has a pending rate application and an emergency rate application.¹⁴
3 There is an important distinction between a regular rate application and an emergency rate
4 application. Namely, there is no test year in an emergency rate application. So, contrary to AWC's
5 assertion, while this rule may contemplate multiple rate filings by a utility, it does not contemplate
6 the use of test years with no actual experience under new rates.

7 Staff agrees with AWC that pro forma adjustments are made to actual test year results and
8 balances to obtain a more realistic relationship between revenues, expenses and rate base.¹⁵
9 However, Staff believes that AWC's complete substitution of test year revenues based on rates that
10 became effective after the test year does not represent a pro forma adjustment as contemplated by the
11 rate case management rule. Instead, it effectively establishes a type of future test year. In other
12 words, pro forma adjustments can be used to make test-year relationships more realistic; they cannot
13 be used to actually create the test year, which is what AWC has done in this case.

14 **B. Staff's Insufficiency Finding Does Not Amount to An Agency Rulemaking.**

15 As the Company notes, the Arizona Administrative Procedures Act ("AAPA") defines "rule"
16 as "an agency statement of general applicability that implements, interprets or prescribes law or
17 policy, or describes the procedure or practice requirements of an agency." A.R.S. § 41-1001(18). "In
18 order to be considered a rule, the statement must implement, interpret or prescribe law or policy, and
19 not be merely an element to aid in the determination of a statutorily mandated valuation."¹⁶ Internal
20 agency guidelines are not "rules" subject to the AAPA.¹⁷

21 Staff's deficiency finding in this matter does not amount to a rulemaking as defined by the
22 AAPA. Rather, Staff's deficiency finding is merely the outcome of the standard review and
23 sufficiency determination process that is mandated by the rate case management rule. The Company

24 _____
25 ¹⁴ Decision No. 57875, Attach. B at 33-34.

¹⁵ R14-2-103(A)(3)(p).

26 ¹⁶ *Canyon Ambulatory Surgery Center v. SCF Arizona*, 225 Ariz. 414, 239 P.3d 733, 739 (Ariz. App. 2010) (citing *Shelby Sch. v. Ariz. State Bd. of Educ.*, 192 Ariz. 156, 167, 962 P.2d 230, 241 (Ariz. App. 1998)).

27 ¹⁷ *Duke Energy Arlington Valley, LLC v. Ariz. Dep't of Rev.*, 219 Ariz. 79, 80, 193 P.3d 330, 334 (Ariz. App. 2008)
(holding that Department of Revenue depreciation tables used for valuation of electric generation facilities were not a
28 'rule' as defined by the AAPA); *Canyon Ambulatory Surgery Center v. SCF Arizona*, 225 Ariz. 414, 239 P.3d 733, 739
(Ariz. App. 2010) (holding that Arizona workers compensation insurance provider's use of a particular pricing
methodology for determining workers' compensation benefits was not a 'rule' subject to the requirements of the AAPA).

1 argues that Staff is implementing a new policy or practice requirement and attempting "to impose
2 new application processing requirements on Arizona Water Company" in violation of the AAPA.
3 However, Staff's deficiency finding in this case is consistent with the Commission's application and
4 interpretation of the rate case management rule since it was amended in 1992.

5 Staff has consistently implemented R14-2-103 to require, at a minimum, a true historic test
6 year with the most recent rates in effect for at least six months of the proposed test year. In fact, as
7 discussed above, it is AWC that is deviating from standard Commission policy by requesting a new
8 interpretation of the rate case management rule to allow for the entire test year to be adjusted pro-
9 forma to account for rates not in effect. Contrary to the Company's assertion, Staff's deficiency
10 finding is based on the Commission's standard interpretation of A.A.C. R14-2-103.

11 **III. ALTERNATIVELY, SHOULD THE COMMISSION DETERMINE THAT AWC'S**
12 **TEST YEAR IS SUFFICIENT FOR PURPOSES OF A.A.C. R14-2-103, THE**
13 **COMMISSION SHOULD NONETHELESS DETERMINE THAT AWC'S**
14 **APPLICATION IS NOT SUITABLE FOR RATEMAKING PURPOSES UNDER THE**
15 **CIRCUMSTANCES PRESENTED BY THIS CASE.**

16 While Staff firmly believes that the use of a proper test year is a fundamental sufficiency
17 issue, in the event that the Commission agrees with AWC's strained reading of R14-2-103, the
18 Commission should determine that AWC's application cannot be processed in its current form
19 because the test year is not suitable for ratemaking purposes. It certainly has not been the
20 Commission's practice to accept rate applications that include a test year where NO present rates
21 were in effect for any part of the test year.

22 In *Arizona Corporation Commission v. Arizona Public Service Company*, 113 Ariz. 368, 555
23 P.2d 326 (1976), the Arizona Supreme Court determined that it was within the Commission's rate-
24 making power to use a historic test year as opposed to a future test year or a mixed historic/future test
25 year. Further, R14-2-103 was amended in 1992 to "improve the efficiency of, and provide greater
26 predictability in the rate review process."¹⁸ The Company's use of this unusual test year will *not*
27 improve efficiency and provide greater predictability--a primary reason for the Commission's
28 amendments to rule 103. In particular, it will take Staff longer to evaluate the baseline of the

¹⁸ Decision 57875, Attach. B at 1:14-15.

1 Company's application because of its use of an unprecedented twelve month pro forma adjustment to
2 impute post-test year rates.

3 **IV. REQUEST FOR WAIVER OF TIMING OF COMMISSION ACTION.**

4 In the event that the Commission determines that AWC's current application is both sufficient
5 for purposes of R14-2-103 and suitable for processing, Staff respectfully requests that the ALJ
6 indefinitely waive or suspend the time clock in this matter pursuant to A.A.C. R14-2-
7 103(B)(11)(3)(ii).

8 Staff believes that the test year being utilized by AWC in its application rises to the level of
9 "[a]n extraordinary event that is not otherwise provided for" The Company asserts that Rule
10 103 does not contain any requirement that twelve months of actual experience under the most current
11 rates approved by the Commission be included in the historical test year. AWC attempts to support
12 this assertion by citing to a handful of Commission decisions from the mid-1980s and early 1990s.
13 However, as discussed above, the Company's reliance on these decisions is misplaced. First, all but
14 one of the decisions that AWC cites are decisions regarding APS that specifically contemplated
15 having multiple-stage proceedings that utilized a single test year. None of these circumstances exist
16 in this case. Second, all of these decisions predate the current version of A.A.C. R14-2-103, the rate
17 case management rule. To the extent that AWC is citing these examples for the proposition that the
18 Commission regularly allows the use of test years with no actual data, that is simply not the case.
19 Just a cursory search on e-docket reveals that the majority of cases filed at the Commission utilize a
20 test year with *some* actual data under current rates. In this case, AWC is utilizing a test year with *no*
21 actual data under current rates.

22 To the extent that there may have been instances in the past wherein the Commission allowed
23 utilities to utilize a test year with no actual data under current rates, Staff believes that this was the
24 exception and not the rule. Further, it is not the Commission's current practice under the current
25 version of the rate case management rule.

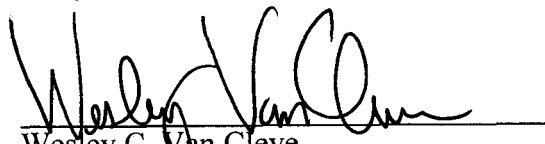
26 **V. CONCLUSION.**

27 Although the Company has not been explicit, it appears that the Company must be
28 experiencing, or at least asserting, some sort of urgent circumstances that caused it to file this

1 application so soon after its last rate case, using a test year wherein the revenues are based on pro
2 forma adjustments. Staff does not believe that the Company's filing meets the sufficiency
3 requirements of the rate case management rules; Staff further believes that the Company's application
4 in its current form is not suitable for processing. Nonetheless, Staff requests that the Commission
5 keep Docket No. W-01445A-10-0517 open, and direct AWC to file a new application in this docket.
6 The Commission should require AWC's new application to include a twelve-month test year with at
7 least six months, preferably twelve months, of actual data using present rates.

8 Ultimately, Staff has limited resources, and these limited resources would be better spent
9 processing AWC's rate case rather than arguing with the Company over the acceptability of its test
10 year. As such, Staff believes that it is in the public interest to require AWC to refile its rate
11 application as discussed above. In the alternative, Staff respectfully requests that the Commission
12 waive the time clock or suspend the time clock indefinitely so that Staff will have sufficient time to
13 properly analyze the Company's unusual test year and application.

14 RESPECTFULLY SUBMITTED this 23rd day of February, 2011.

15 
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21 **of the foregoing filed this**
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